Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted] TL-N-8066-98
[redacted]

date: November 7, 2000

to: [redacted], Manager, SBSE Division Group [redacted]
Attn: Revenue Agent [redacted]

from: Associate Area Counsel [redacted]
CC: [redacted]

subject: [redacted]

U.I.L. Nos. 162.00-00; 162.21-01; 197.00-00; 263.00-00

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Reference is made to your request of October 20, 2000 for advice on the impact information you obtained during recent interviews has on the deductibility of amounts paid by [redacted] pursuant to civil settlements with the [redacted] and [redacted] County. We have expedited our response to your request following your notification to us on October 31, 2000 that you intend to close the case no later than [redacted].

Background

The facts, as we understand them, are as follows:

[redacted] agreed in [redacted] to pay the [redacted] (the "[redacted]") and the [redacted] County [redacted] $[redacted] and $[redacted], respectively, to resolve claims relating to pollution caused by a [redacted] at [redacted]'s [redacted]. The applicability of Code section 162(f) to amounts paid pursuant to the settlement was the subject of our advice dated January 21, 1999, February 5, 1999, and June 8, 1999.

In our memorandum of advice dated January 21, 1999, we noted that it has been suggested that the $[redacted] was accepted by the [redacted] in lieu of requiring [redacted] to perform additional remediation work that it might have been required to perform under [redacted] law. We noted further that that suggestion appeared to be supported by the [redacted] report that [redacted] the [redacted] commissioner, had stated that [redacted] had decided that punitive fines were inappropriate because [redacted] had moved promptly to replace damaged resources. We emphasized the importance of interviewing the parties who negotiated the settlement on behalf of the [redacted]. We stated that:

> If those interviews establish that the $[redacted] was accepted by the [redacted] in lieu of requiring [redacted] to perform specific additional remediation work that it might have been required to perform under [redacted] law and that the [redacted] had in fact decided that penalties under the penalty statutes referred to in the Order on Consent were inappropriate, then [our opinion that the facts as then developed appeared to support the argument that Code section 162(f) bars the deduction of the $[redacted] was required to pay the [redacted] for natural resources damages under section V of its agreement with the [redacted]] would likely change.

In our February 5, 1999 memorandum regarding the issue, we reported that National Office subject matter specialists had agreed with the recommendation that you interview the relevant parties to fully ascertain the purpose of the payment. We emphasized that the focus of the inquiry should be on what the $[redacted] was in lieu of rather than simply on whether the [redacted] decided that it would be appropriate to impose fines. We emphasized that the facts developed at the time did not establish that the issue was necessarily an all or nothing issue. We stated that:

> If the interviews establish that the DEC decided not to impose fines because [redacted] agreed to pay the $[redacted] then we believe it would support the conclusion that the $[redacted] should be treated as a fine or penalty. That conclusion is supported by the United States Court of Appeals for the Second Circuit's recent opinion in Murillo v. Commissioner, 83 AFTR2d ¶99-373(copy attached). That opinion reasoned that a payment that took the place of a fine constituted a fine or similar penalty under Code section 162(f).
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> If the interviews instead establish that [redacted]'s agreement to pay the $[redacted] was one but not the sole factor in the [redacted]'s decision to forgo imposing fines, then we

[redacted]

believe it would support a conclusion that at least part of the $[redacted] should be treated as a fine or penalty.

In contrast, if the interviews establish that the $[redacted] was in lieu of specific additional remediation work that [redacted] might have been required to perform under [redacted] law and that the [redacted] would not have imposed fines even if [redacted] had not agreed to pay the $[redacted] then, as stated in our opinion, it would indicate that the $[redacted] does not constitute a fine or similar penalty under Code section 162(f).

You have now interviewed [redacted] and [redacted] personnel as we recommended. Based on those interviews, we believe the final paragraph quoted immediately above applies.

We understand that you interviewed two [redacted] personnel on [redacted] and [redacted]. They told you that the [redacted] had never contemplated or discussed penalizing [redacted] for the [redacted] because [redacted] had voluntarily reported it. They explained that the [redacted] and [redacted] had been negotiating the extent of the remediation work that [redacted] would be required to perform to satisfy its cleanup obligations. Essentially, [redacted] wanted to do less and the [redacted] wanted it to do more. The minutes of your interview state as follows:

> Responding to engineers' questions, [redacted] responded to the effect, that: Typically [redacted] demands complete cleanup, that means cleaning up to the pre-contamination state. However, in view of the "near" indefinite nature of [redacted] remediation project, [redacted] took an initiative to negotiate with the [redacted] on the possible "project closing criteria", so that the company did not have to continue to [redacted] treat system beyond a predetermined date.

We understand that at one point during the negotiations, [redacted] proposed that it would pay the [redacted] $[redacted] and the [redacted] $[redacted] if the [redacted] would agree to its project closing criteria. The [redacted] personnel said that they were surprised by the proposal, but agreed to it. They also said that they had no knowledge of how the amount of the $[redacted] payment to the [redacted] had been arrived at.

We understand that you interviewed [redacted] personnel, including [redacted], on [redacted]. [redacted] was familiar with the circumstances surrounding [redacted]'s agreement

[redacted]

to pay $[redacted] to the [redacted]. He reported that the [redacted] had come to the [redacted], reported that a settlement was being negotiated, and asked how much the [redacted] wanted. He said that after internal discussions the [redacted] decided to request $[redacted]. He emphasized that the amount was not a fine or penalty, and that the [redacted] had no authority to impose a fine or penalty. Paragraph 4.(a) of the settlement agreement between [redacted] and the [redacted] recites that the $[redacted] was:

> to be expended as the [redacted] deems appropriate for the purposes of monitoring the [redacted] at the [redacted] in the [redacted] the "[redacted]") and for implementing measures to remediate [redacted] contamination at the [redacted], if any, including but not limited to [redacted] treatment, [redacted] and relocation [redacted].

Paragraph 4.(a) states that the $[redacted] was in satisfaction of all claims against [redacted] the [redacted] "may now or ever have relating to or arising from [redacted] contamination at the [redacted]."

Issues

1. Whether the facts developed provide a reasonable basis for taking the position that Code section 162(f) bars the deduction of the $[redacted] that [redacted] agreed to pay the [redacted] and the [redacted]?

2. Whether the facts developed provide a reasonable basis for taking the position that all or part of the $[redacted] that [redacted] agreed to pay the [redacted] and the [redacted] must be capitalized?

Conclusions

1. The facts developed do not provide a reasonable basis for taking the position that Code section 162(f) bars the deduction of the $[redacted] that [redacted] agreed to pay the [redacted] and the [redacted].

2. The facts developed do not provide a reasonable basis for taking the position that all or part of the $[redacted] that [redacted] agreed to pay the [redacted] and the [redacted] must be capitalized.

Discussion

Based on your interviews with [redacted] and [redacted] personnel, we believe there is no reasonable basis for taking the position that Code section 162(f) applies to the $[redacted]. That section

[redacted]

provides that no deduction shall be allowed under Code section 162(a) for fines or similar penalties paid to a government for violating the law. Your interview with the [redacted] personnel established that the $[redacted] that [redacted] agreed to pay the [redacted] was neither a fine or similar penalty nor an amount paid in lieu of such because the [redacted] had never contemplated or discussed penalizing [redacted] for the [redacted]. Your interview with the [redacted] personnel established that the $[redacted] agreed to pay the [redacted] was neither a fine or similar penalty nor an amount paid in lieu of such because the [redacted] had no authority to impose any fines or penalties. Your interviews failed to establish any evidence that any of the $[redacted] was in lieu of a fine or penalty that might have been asserted by a party other than the [redacted] or [redacted].

Engineering personnel have suggested that some or all of the $[redacted] might be considered a capital expense. We do not believe the facts developed to date support the view that any of the $[redacted] should be considered a capital expense. We believe the facts support the view that [redacted] paid the $[redacted] to convince the [redacted] to accept the "project closing criteria" that [redacted] had proposed, thereby limiting its remediation obligation.

Sums paid in compromise of a liability, whether determined or not, take on the character of the underlying asserted obligation. See Adolf Meller Co. v. U.S., 600 F.2d 1360, 1363-64 (Ct. Cl. 1979)(stating that settlement payment is to be treated as being of the same character as the underlying asserted obligation); Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136, 1144-45 (1979) (stating that character of settlement payment depends on liability giving rise to it). The obligation that [redacted] paid the $[redacted] to compromise was its pollution remediation obligation under [redacted] law. The Service's position is that costs incurred to clean up [redacted] that a taxpayer contaminated with hazardous waste from its business are deductible as ordinary and necessary business expenses under Code section 162 except to the extent that they are allocable to capital items. Rev. Rul. 94-38, 1994-1 C.B. 35. Here, the facts do not support the allocation of any of the $[redacted] to capital items.[1]

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[1] Engineering personnel have suggested that Code section 197 might apply in these circumstances. That section entitles taxpayers to amortization deductions with respect to "amortizable section 197 intangibles." We are unable to conclude that the facts support a determination that [redacted]'s payment of the $[redacted] would create for [redacted] an intangible asset to which Code section 197 would apply. We view the payment as

[redacted]

It does not appear that [redacted] will obtain an interest in any depreciable assets as a result of paying the $[redacted]. Cf. Rev. Rul. 79-264, 1972-2 C.B. 92. Similarly, although [redacted] may have believed that it was better from a public relations standpoint for it to pay the $[redacted] in lieu of incurring additional remediation expenses, or even have paid the $[redacted] to improve its damaged public image, we do not believe that would require the $[redacted] to be capitalized. See Treas. Reg. § 1.162-20(a)(2)(stating that expenses for goodwill advertising are generally deductible); Rev. Rul. 92-80, 1992-2 C.B. 57 (ruling that Indopco does not affect the deductibility of advertising costs).

This opinion is based on the facts set forth herein. It might change if the facts are determined to be incorrect or if additional facts are developed. If the facts are determined to be incorrect or if additional facts are developed, this opinion should not be relied upon. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If we can be of further assistance, you may call the undersigned at [redacted].

[redacted]
Area Counsel [redacted]

By: [redacted]
Senior Attorney

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satisfying an asserted liability rather than as creating a future intangible right.

[redacted]